Summary

The deficit for 2006 will be notably lower than the Congressional Budget Office (CBO) estimated in March, when it issued its previous projections of the federal budget. The broad fiscal outlook for the coming decade, however, has not changed materially since then. The underlying projections of outlays and revenues for future years are similar to those presented five months ago, with the exception that the current projections of spending from this year's appropriations are now higher—reflecting the extrapolation of recent supplemental funding primarily for the war in Iraq and hurricane relief.

The Budget Outlook

CBO now expects the 2006 deficit to total $260 billion—a $58 billion decline from the deficit recorded for 2005 (see Summary Table 1). Relative to the size of the economy, the deficit this year is expected to equal 2.0 percent of gross domestic product (GDP), down from 2.6 percent in 2005.

CBO's current estimate of the deficit for 2006 is $112 billion lower than the amount that it estimated when it analyzed the President's budgetary proposals in March.[1] Higher-than-anticipated revenues, mostly from individual and corporate income taxes, account for the bulk of that improvement. CBO now expects 2006 revenues to exceed its March estimate (including the President's proposals) by $99 billion, or about 4 percent. At the same time, outlays this year are expected to be $13 billion—or less than 0.5 percent—below CBO's March estimate (including the impact of proposed supplemental appropriations), primarily because of lower-than-anticipated spending on the government's major health care programs, Medicare and Medicaid.

CBO has also updated its baseline budget projections for the coming decade. By statute, those projections must assume that current laws and policies remain in place.[2] The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and revenues.

The general fiscal outlook for the coming decade remains about the same as what CBO projected in March. If the laws and policies currently in place did not change, the deficit would remain at around this year's level over the next few years relative to the size of the economy, CBO projects. After 2010, it would decline sharply, reflecting the rapid increase in tax revenues that would occur after provisions initially enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expired. By 2016, the deficit would decline to 0.4 percent of GDP, according to CBO's baseline projections.

Total outlays are projected to remain relatively steady at roughly 20 percent of GDP over the next 10 years (see Summary Figure 1). Mandatory outlays are estimated to grow nearly 1.5 percentage points faster each year than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation and thus at about half the growth rate of GDP. (CBO projects that

1. In March, CBO projected that the 2006 deficit would total $371 billion if the President's proposals for supplemental funding and other policy changes were enacted and $336 billion assuming that those changes to policy did not occur. (Supplemental appropriations similar to those proposed by the President were later enacted.) See Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007* (March 2006).

2. Exceptions exist for mandatory programs established on or before the date the Balanced Budget Act of 1997 was enacted and for expiring excise taxes that are dedicated to trust funds.

Summary Table 1.

CBO's Baseline Budget Outlook

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							In Billions of Dollars							
Total Revenues	2,154	2,403	2,515	2,672	2,775	2,890	3,156	3,398	3,555	3,733	3,922	4,118	14,007	32,733
Total Outlays	2,472	2,663	2,801	2,945	3,079	3,217	3,382	3,451	3,631	3,797	3,979	4,211	15,425	34,494
Total Deficit (-) or Surplus	**-318**	**-260**	**-286**	**-273**	**-304**	**-328**	**-227**	**-54**	**-76**	**-64**	**-56**	**-93**	**-1,418**	**-1,761**
On-budget	-493	-437	-471	-478	-526	-567	-481	-318	-346	-340	-333	-369	-2,522	-4,228
Off-budget[a]	175	177	185	204	221	239	254	264	270	275	277	276	1,104	2,466
Debt Held by the Public at the End of the Year	4,592	4,851	5,149	5,434	5,750	6,088	6,324	6,387	6,469	6,539	6,600	6,696	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	17.5	18.3	18.2	18.4	18.2	18.1	18.9	19.4	19.4	19.5	19.7	19.8	18.4	19.0
Total Outlays	20.1	20.3	20.3	20.3	20.2	20.1	20.2	19.7	19.9	19.9	19.9	20.2	20.2	20.1
Total Deficit	**-2.6**	**-2.0**	**-2.1**	**-1.9**	**-2.0**	**-2.0**	**-1.4**	**-0.3**	**-0.4**	**-0.3**	**-0.3**	**-0.4**	**-1.9**	**-1.0**
Debt Held by the Public at the End of the Year	37.4	37.0	37.3	37.5	37.7	38.1	37.8	36.5	35.4	34.2	33.1	32.2	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	12,294	13,108	13,823	14,509	15,236	15,989	16,727	17,488	18,286	19,109	19,951	20,827	76,284	171,945

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

annual growth of nominal GDP will average 4.7 percent over the 2007–2016 period.)

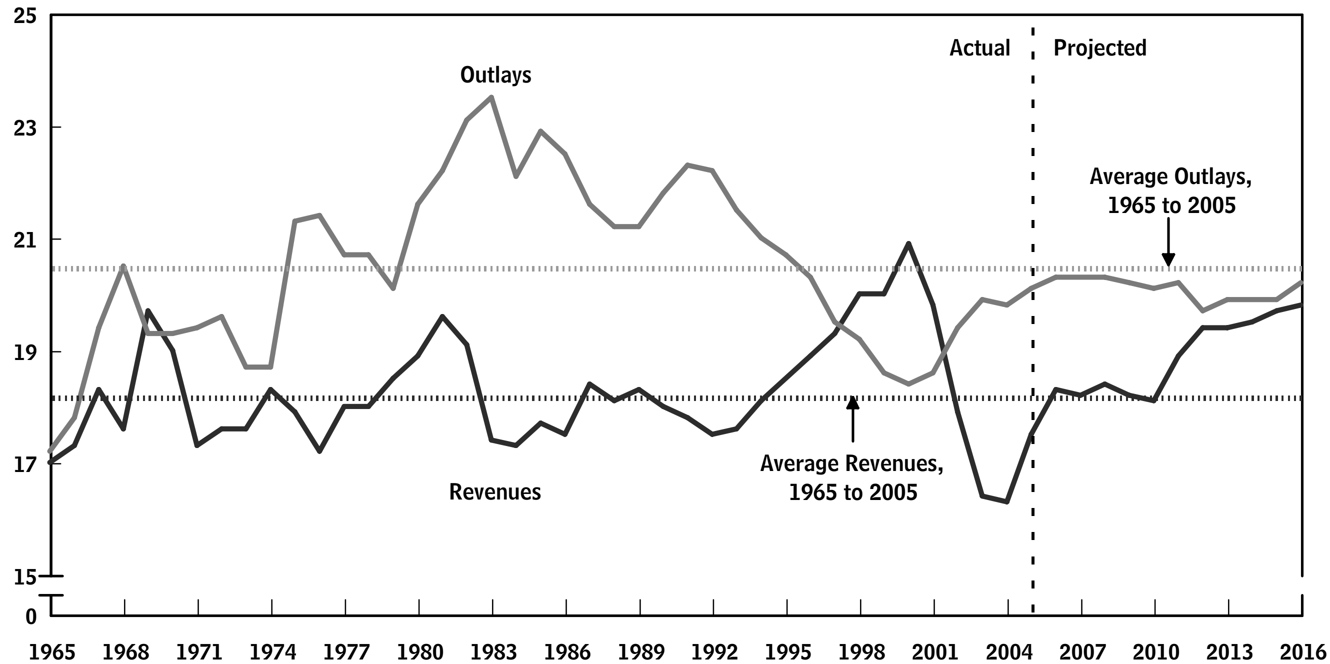
The path of federal revenues over the next 10 years is influenced by the scheduled expiration of numerous tax provisions originally enacted between 2001 and 2003. Through 2010, total revenues are projected to remain close to their 2006 level relative to the size of the economy: 18.3 percent of GDP. If the remaining tax provisions from EGTRRA and JGTRRA expire in December 2010 as scheduled, revenues will rise sharply, reaching 19.8 percent of GDP in 2016.

Individual income taxes account for the projected rise in revenues as a percentage of GDP over the next 10 years. Revenues from corporate income taxes are projected to peak this year at 2.6 percent of GDP (a level last reached in 1979) and then gradually diminish. Other sources of revenues, the largest of which is social insurance taxes, are estimated to remain relatively stable as a share of GDP.

The cumulative deficit for the 2007–2016 period in CBO's baseline has risen by $1.0 trillion since the agency's last set of baseline estimates (published in conjunction with its analysis of the President's budget). However, the changes do not indicate a significant shift in the budgetary outlook; rather, they result mostly from extrapolating into future years nearly $95 billion in supplemental appropriations enacted since March, as required under the rules governing the baseline. Changes in the economic outlook and other (technical) estimating revisions have decreased projected deficits by about $80 billion a year for 2007 and 2008, about $50 billion for 2009, and an average of $28 billion a year for 2010 through 2016.

Summary Figure 1.

Total Outlays and Revenues as a Percentage of Gross Domestic Product, 1965 to 2016



Source: Congressional Budget Office.

Spending on Social Security, Medicare, and Medicaid is projected to grow rapidly during the 10-year period covered by CBO's baseline (see Summary Figure 2); the resulting budgetary pressures will intensify in later years as the baby-boom generation ages and health care costs continue to rise. The percentage of the population age 65 or older will continue to increase (from 14 percent in 2016 to more than 19 percent in 2030). In addition, health care costs are likely to keep growing faster than GDP, as they have over the past four decades. As a result, spending for Social Security, Medicare, and Medicaid will exert pressures on the budget that economic growth alone is unlikely to alleviate. Consequently, substantial reductions in the projected growth of spending and perhaps a sizable increase in taxes as a share of the economy will probably be necessary to maintain fiscal stability in the coming decades.[3]

3. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005) and *Updated Long-Term Projections for Social Security* (June 2006).

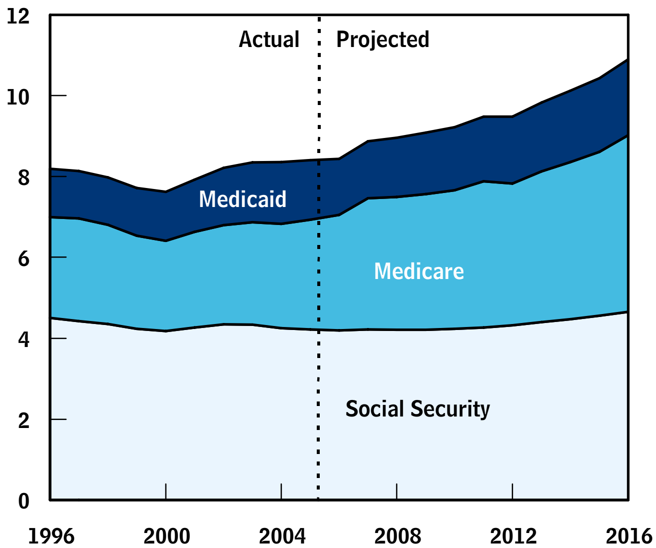
The Economic Outlook

Although the U.S. economy has been growing at a rapid rate since early 2003, its growth is likely to slow to a moderate, sustainable pace over the next year and a half. CBO forecasts that economic growth will diminish to an annual rate of 3 percent in real (inflation-adjusted) terms in the second half of this calendar year and then remain steady at that rate through 2007. Inflation in so-called core consumer prices (which exclude the more volatile prices of food and energy) will also moderate, CBO expects, dropping to 2 percent by the end of next year. CBO anticipates that the unemployment rate will average about 4¾ percent through 2007 and that the growth of productivity will be roughly 2 percent. Interest rates on Treasury securities will rise in the second half of this year, CBO forecasts, and then drop slightly during 2007.

Several major forces influence the economic outlook. Working to keep inflation under control, the Federal Reserve moved to a slightly restrictive stance in 2006, after having gradually removed the stimulus to short-term growth that it had maintained for several years. As a result, interest rates—especially those for short-term

Summary Figure 2.

Spending on Social Security, Medicare, and Medicaid as a Percentage of Gross Domestic Product, 1996 to 2016



Source: Congressional Budget Office.

securities—have increased. At the same time, energy prices have risen, largely as a result of developments in world markets for petroleum and petroleum products, and the housing market has begun a long-anticipated slowdown. Those factors are expected to restrain the growth of consumers' purchases of goods and services, as higher interest rates reduce borrowing by consumers, higher energy prices reduce households' real income, and the decline in the growth of house prices slows the rise in households' wealth.

The outlook for investment by businesses in new structures, equipment, and software (business fixed investment) is bright. Demand for goods and services from domestic and foreign customers is still solid, so after investing at low rates in 2002 and 2003, businesses are now seeking to add capacity. In addition, firms' profits are high, corporate debt is relatively low, and the cost of financing for investment is still favorable.

Over the next 10 years, economic growth is projected to slow, as the members of the baby-boom generation begin to leave the labor force. In CBO's estimation, average annual growth of real GDP will decline from 3 percent in 2008 through 2011 to 2.6 percent in 2012 through 2016 (see Summary Table 2). Both core and overall inflation, as measured by the growth of the price index for personal consumption expenditures, will average 2 percent over the 2008–2016 period, and the unemployment rate will average 5 percent. The average annual interest rate on three-month Treasury bills over the period will be about 4.5 percent, CBO projects; the rate on 10-year notes will average 5.2 percent.

Summary Table 2.

CBO's Economic Projections for Calendar Years 2006 to 2016

(Percentage change)

	Actual	Forecast		Projected Annual Average	
	2005[a]	2006	2007	2008 to 2011	2012 to 2016
Nominal GDP (Billions of dollars)	12,487	13,308	13,993	16,914 [b]	21,052 [c]
Nominal GDP	6.4	6.6	5.1	4.9	4.5
Real GDP	3.5	3.5	3.0	3.0	2.6
GDP Price Index	2.8	3.0	2.0	1.8	1.8
PCE Price Index[d]	2.8	3.0	2.4	2.0	2.0
Core PCE Price Index[e]	2.0	2.2	2.3	2.0	2.0
Consumer Price Index[f]	3.4	3.5	2.5	2.2	2.2
Core Consumer Price Index[g]	2.2	2.6	2.5	2.2	2.2
Unemployment Rate (Percent)	5.1	4.7	4.8	5.0	5.0
Three-Month Treasury Bill Rate (Percent)	3.1	4.8	5.0	4.5	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.4	5.2	5.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis (BEA); Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: GDP = gross domestic product.

Percentage changes are year over year.

a. Values are as of early July 2006, prior to revisions that BEA has since made to the national income and product accounts.

b. Level in 2011.

c. Level in 2016.

d. The personal consumption expenditure chained price index.

e. The personal consumption expenditure chained price index excluding prices for food and energy.

f. The consumer price index for all urban consumers.

g. The consumer price index excluding prices for food and energy.